Value Investing Reference for Gemma Model

There are two kinds of investors. Defensive investors aim to protect their capital from losses, generate decent returns and minimize frequent decisions. Enterprising investors devote most of their time to manage their portfolios actively. An enterprising investor does not take more risks than a defensive investor but invests more in stock selection.

Part-time investors should stick to defensive investment strategies. Defensive investors can achieve a decent result with minimum effort and capability. However, even a marginal improvement from this result is challenging and requires extraordinary knowledge and skill. An attempt to outsmart the market by spending a little extra time and effort will primarily result in below-average gains.

Confusing speculation with investment can be a costly mistake. Speculators buy hot stocks based on future growth prospects. In contrast, investment is made on a thorough analysis of the underlying business to ensure the safety of principal and adequate — but not extraordinary — gain. Invest in a stock only when you can comfortably own it without following its daily share price.

If you cannot resist the urge to bet on the next big growth stock, set strict limits on speculation. Keep a separate speculative account with less than 10% of your capital for speculative activities. Never mix money from the investment account and speculation account.

It's a risky idea to speculate on high-growth industries, and high-growth stocks are a risky idea. The growth prospects for a business do not necessarily result in profits for investors. Because these stocks are often overpriced, growth may not result in proportional returns. Only eight of the largest 150 companies on the Fortune 500 list managed to grow earnings by at least 15% over two decades.

Graham strongly urges investors to stay away from Initial Public Offerings. IPOs often happen in bull markets and lead to inflated valuations. When the bear market begins, these overheated speculative stocks are the first to crash and cause severe losses. An investor who bought every IPO at its public closing price and held on for three years, from 1980 to 2001, would have underperformed the market by 23% annually. A sure way to predict the end of a bull market is when the stocks of new nondescript small businesses are priced higher than reputed medium-sized companies. The bull run of the 1980s saw over 4000 stocks created. This led to the 1987 crash. IPOs dried up between 1988 to 1990, which led to the 90's bull market. During this time, over 5000 new stocks were created, which led to the 2001 crash of the dot com bubble.

It is dangerous for ordinary investors to time the market. Value investors instead identify and invest in large, conservatively financed companies whose present value as estimated by tangible assets is substantially below their current stock prices. There is no attempt to predict an uncertain future, and there is enough margin to absorb unfavorable developments.

Never buy any security far above its tangible asset value. Though outstanding companies are often worth several times their tangible asset value, the investor becomes too dependent on stock market fluctuations. In contrast, an investor who purchases stocks close to tangible asset value can ignore market fluctuations, confident that he has bought an interest in a sound business for a reasonable price.

Price and value are two different concepts. Think of Mr. Market as an irrational investor in a business you also invested in. He frequently changes his mind and quotes wildly different prices for your share. His behavior will hardly change your fundamental perception about the value of the business. However, you would gladly buy when his price is far lower than the business value and sell when his price is far higher than the business value.

The start of a bear market is good news for intelligent investors. They recognize that stocks become riskier as their prices rise and less risky as their prices crash. A bear market is a considerably safer time to buy stocks close to their asset value and build sustainable wealth.

A defensive investor's portfolio must have 50% in high-grade bonds and 50% in common stocks irrespective of market conditions. Doing so will prevent them from buying excess shares in a bull market and rushing into bonds in the bear market. Once they set up their portfolio, the defensive investor checks every six months to rebalance it if market change alters this ratio by over 5%.

Enterprising investors' confidence in their professional analysis may reduce their stock component to 25% when the markets are dangerously high and raise their stock component to 75% at the bottom of a bear market. However, a minimum of 25% in bonds is essential as it will give investors the cushion to hold on to stocks even through the worst bear markets.

Purchase only tax-free municipal bonds unless you fall in the lowest tax bracket. Choose bonds that mature in five to 10 years as they remain relatively stable with interest rate fluctuations. Bond funds are an excellent choice for individual investors as they offer cheap and easy diversification to minimize risk.

Both Graham and Warren Buffet recommend index funds as the best long-term bet for defensive investors. Index funds own a cross-section of the entire market without any stock selection. While they may be unglamorous and show steady returns compared to more aggressive funds, index funds have low risk and have historically outperformed most mutual funds over 20 year periods.

If you enjoy stock selection, make the index fund the foundation of your portfolio and experiment with around 10% of funds. Buy only stocks priced below 22.5 times the average 12-month earnings. The stock price must not be higher than 1.5 times the book value. If the book value multiplier is low, the earnings multiplier can be higher. But the product of the multiplier of earnings and multiplier of book value should not exceed 22.5.

Do not be swayed by home bias. Familiarity often prevents investors from doing the required due diligence before picking a stock. Many average investors make the mistake of buying familiar stocks or stocks of their own companies. On average, 401(k) investors keep between 25% to 30% of their retirement assets in their company's stock.

Graham insists on using a multi-year average of past returns to calculate Price/Earnings ratio. Consider a company that earned $0.50 per share over six years but earned $3 over the last 12 months. At 25 times the P/E ratio based on the last year, the stock would be valued at $75. In contrast, valued at 25 times the average earnings over the past seven years, the stock would be valued at just $21.43.

Prevention of losses takes priority over improving gains. Assume an investor buys a stock at the peak of a bull market that can generate 5% above average market returns. The bull market ends, and the stock drops by 50% the following year. Even if the stock gains 10% every year, it will take beyond 16 years to overtake market returns.

The margin of safety is essential to ensure against loss and improve upside potential. The stock price must be substantially lower than its underlying tangible asset value. In 1973, Warren Buffet invested in The Washington Post when it was priced at $83 million, and its assets were worth at least $400 million. The investment had both a substantial margin of safety and massive growth potential.

Graham designed his approach to craft a reliable portfolio that requires minimum maintenance and offers maximum odds of a steady return. By sticking to a formula for investment decisions, the defensive investor gives up the risk of speculating on stock movements and gains steady returns. After the initial curation, if the investor trades more than twice a year, it is a clear sign something has gone wrong.

Summary

Price and value are two different concepts, and stock prices frequently don't reflect a company's actual value. More risk does not necessarily correlate with more gain. On the contrary, a substantial margin of safety and the difference between stock price and fundamental asset value can protect against loss while improving potential upside. Value investing can help you create a core portfolio that frees you from the need to track market prices and guarantee maximum odds of a steady return.